DOW THEORY LETTERS INC.

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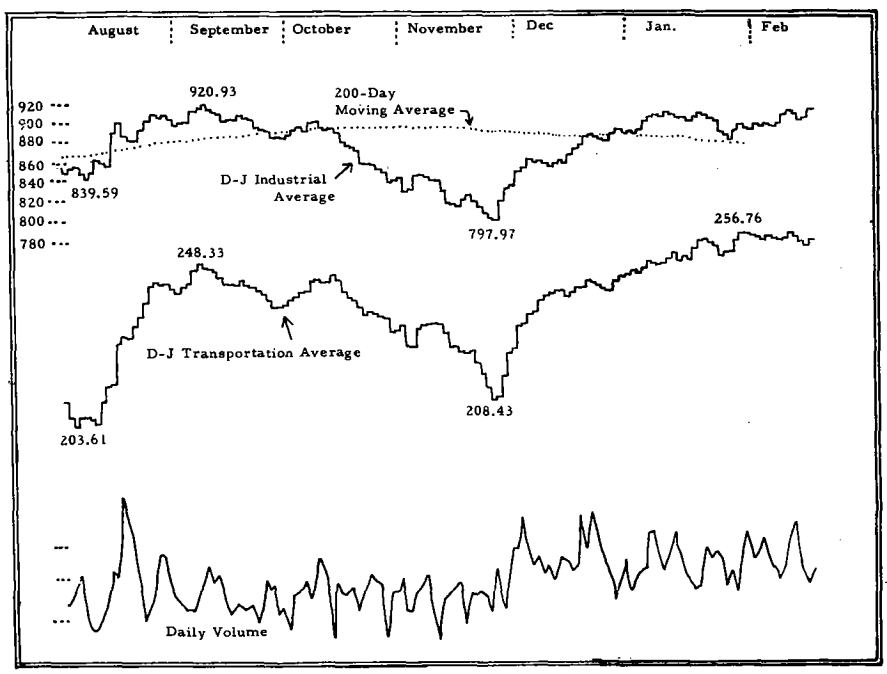
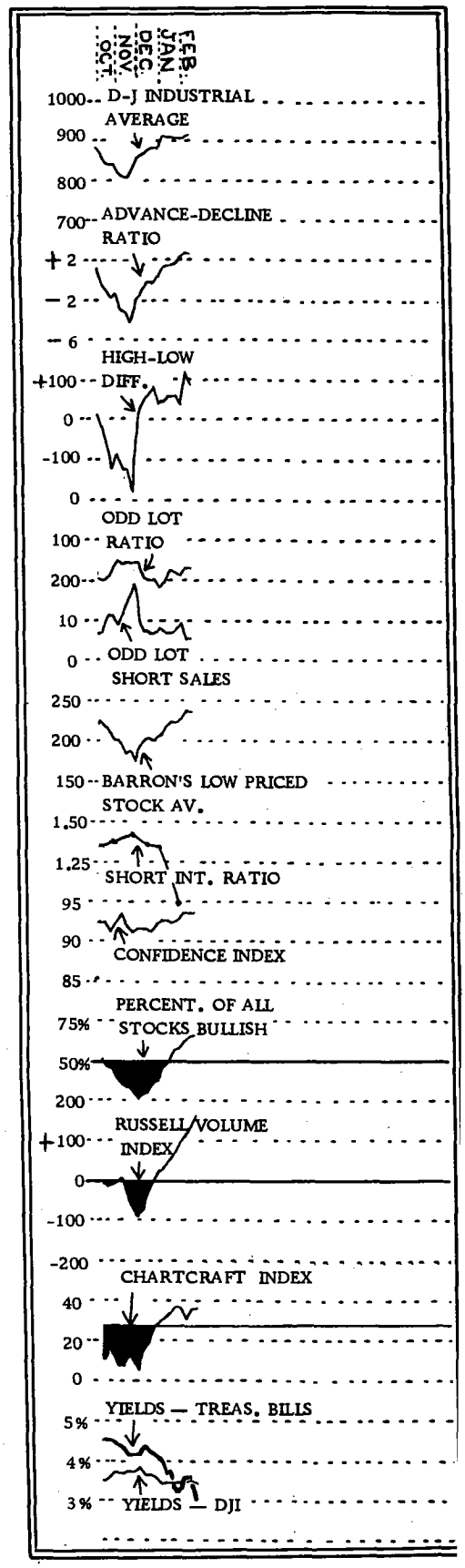
THE PICTURE: While speculation turns rampant on the U.S. stock exchanges, our overseas creditors (see news clip) are making plans to save their economic skins via an honest, non-balloonable currency which will be European. As to the U.S. dollar, Market Kinetics (Jim Sibbet) said the following this week: "The (U.S.) money supply is now at another all time high of $229.8 billion. Divide this into the amount of gold left and you get 1/23rd of a dollar or 4.3¢, which is all the dollar is worth now in terms of gold at $35 per ounce. It would require a 23 to 1 devaluation to squeeze all the water out of today's dollar. Of course, by the time the Government goes bankrupt and is forced back to a gold standard, the water in the dollar will be many times greater..."

As a postscript to Mr. Sibbet's ominous comments, on February 15, it was announced that the U.S. balance-of-payments deficit for 1971 was a record-breaking $29.6 billion. This single year's deficit is equal to three times the total current U.S. gold reserves. Is it any wonder the price of gold is rising?

Wall Street's job is to decide whether these whopping deficits and the oceans of fiat money being ground out by U.S. printing presses to cover them are bullish or bearish for America and the world over the period ahead. On February 10 the D-J Industrial Average closed at 921.28, exactly 35¢ above the September 8, 1971, close of 920.93. This half-hearted penetration confirmed the previous advance by Transports above their own which immediately took Industrials below their September, 1971, peak. This indicated a lack of force on the upside penetration, and it was accompanied by a further drop in the Utility Average as that indicator flirted with its 1972 low.

The question, then, is are the Averages showing more strength now (i.e., at their February peaks) than they were at their peaks of last September? Certainly it has taken a great deal more volume to put the Averages at roughly the same level as they





were last September. And since mid-January the Averages have tended to be "out-of-gear", one sagging while the other advanced with Utilities having turned weak almost from the beginning of the year.

It appears to me that the market is now turning more and more ragged, with rallies failing to "get it all together" on the upside (each Dow rally now seems to have one or more divergences, such as Utilities, Transports or A-D ratio). Daily new highs also seemed to have reached their peak on February 2 at 159. With Transports now turning weak, I would say that the first solid indication of trouble would be a breaking of the January 26 Industrial low of 889.15 on increasing volume. If that happens, I would guess that the February 10 peak of 921.28 could well stand as the Industrial high for 1972 (and that, I venture, is a very contrary opinion).

The "Sentiment Index" (from Merrill Analysis, P.O.Box 228, Chappaqua, N.Y. 10514) which is the ratio of bullish to bearish investment services is now at 4, meaning that there are four bullish services for every one bearish. This is near the highest this indicator ever gets, and if one is to believe William Hamilton's dictum that "the majority of professional opinion is seldom right", then this should be a time for extreme caution.

MOST ACTIVE STOCKS: Periodically I have presented studies of the "most-active stocks" on the N.Y.S.E. During any extended period, the 20 most-active stocks (tabulated weekly in Barron's) will account for about 15% of all N.Y.S.E. volume. While this is a large percentage, the more significant fact is that the direction of the most-actives usually sets the direction for the rest of the market. Often, the most actives will lead the general market in trend, both up and down.

Plan for a European Currency

Paris

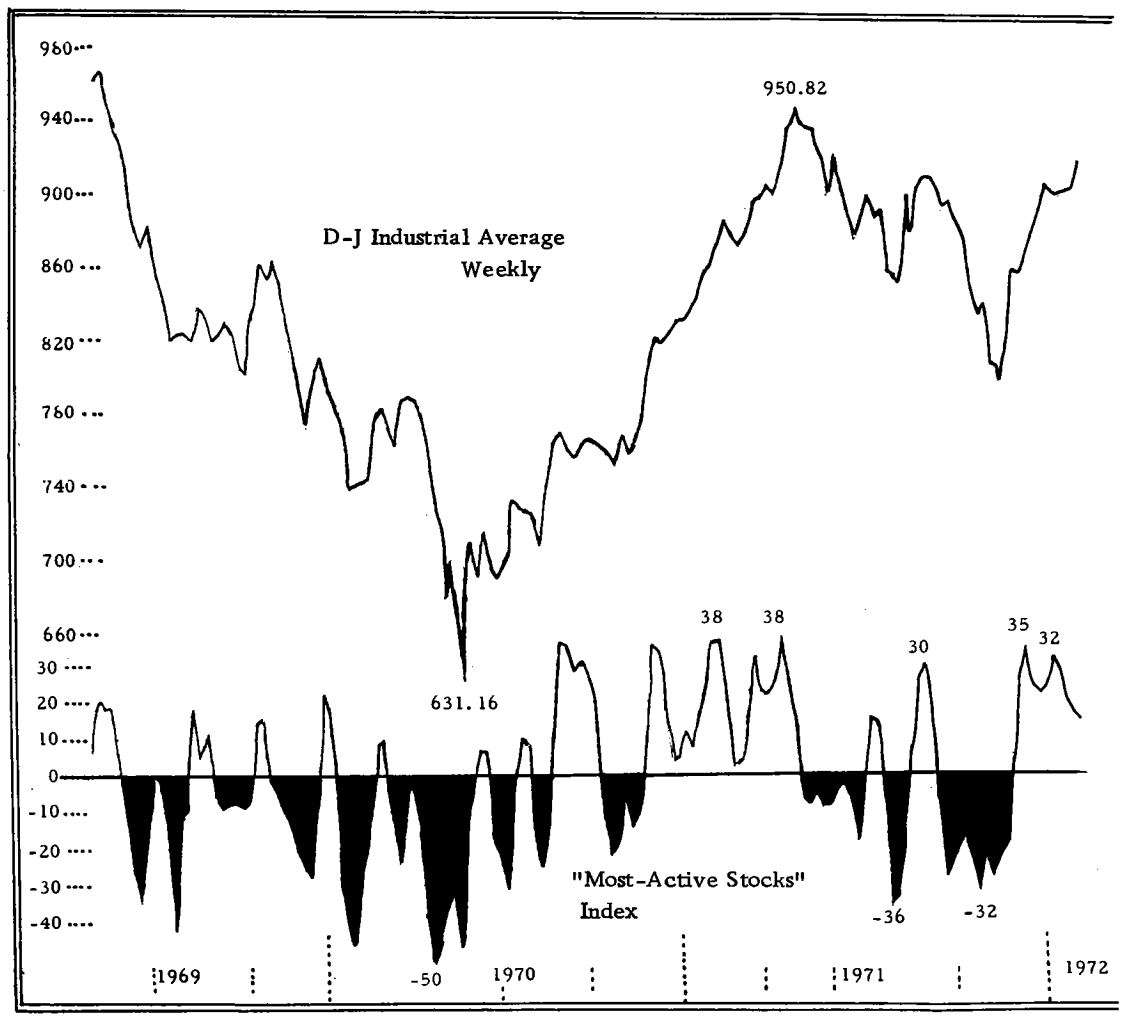
France and West Germany agreed yesterday to propose to the rest of the European Common Market nations a policy of monetary and economic unity that would eventually bring a common currency to Western Europe.

French President Georges Pompidou and West German Chancellor Willy Brandt decided at a conference to propose the policy to other members of the trading alliance February 28 in Brussels.

I use a simple index for gauging the trend of the most-actives. Each week I tabulate the plurality of the 20 most-active stocks. For instance, if 15 stocks advanced and 5 declined, there would be a plurality of plus 10. These weekly pluralities are then arranged in the form of a three-week moving average (actually, this means that they are arranged in the form of three weeks totals of the pluralities).

The accompanying chart traces the most-active index from 1969 to the present. On the downside, note how accurately the most-active index measured the amount of selling pressure during the late 1971 decline. On the August decline to 839 on the Dow, the most-active index registered a minus 36. On the later plunge to the November low of 797, the most-active index registered minus 32, an improvement. This proved to be the beginning of the big rally to the 921 peak of January, 1972.

On the week ending Dec. 17, 1971, the index struck a high of plus 35 (see chart), and this proved to be the 1971-72 peak. During that week the Dow closed at 873. On the week ending January 14, 1972, the index registered plus 32, but that same week saw the Dow close at 906. This was the first upside non-confirmation on



the index, and since then the index has dropped to its most recent reading (week closing February 11) of plus 15.

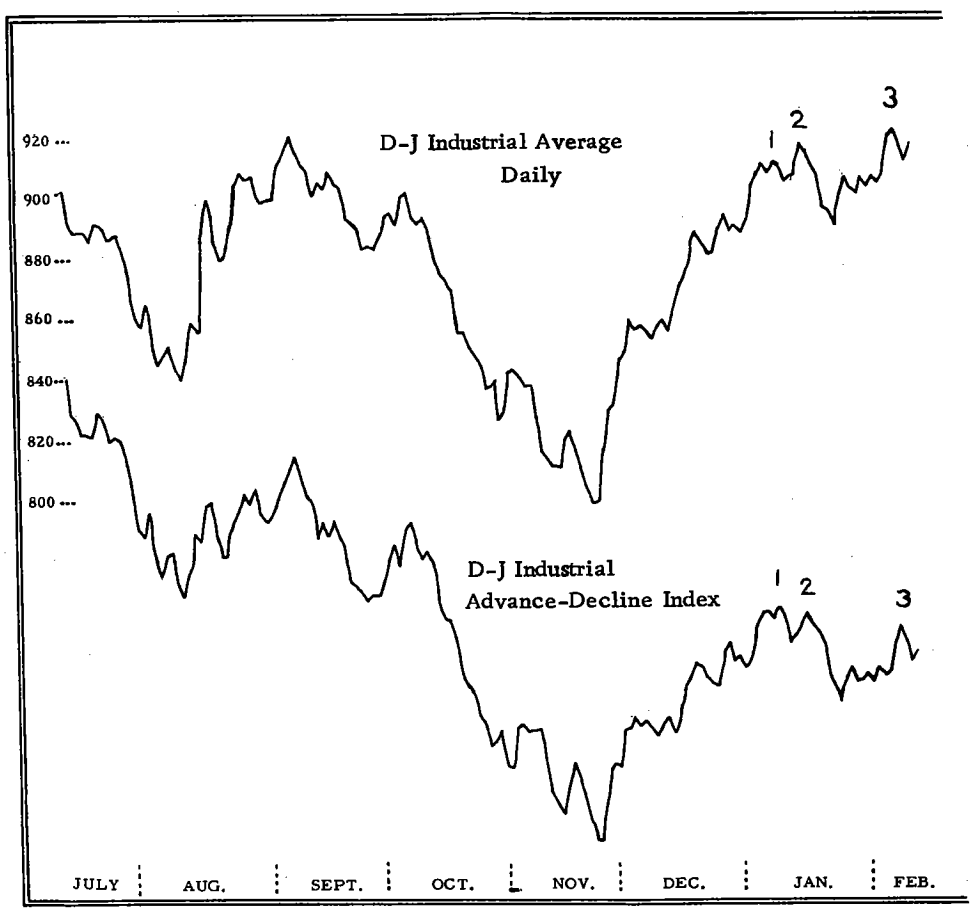
The most-active index will be worth watching closely from here on. The non-confirmation discussed on page 2 constitutes the first danger signal, and it will be important to see whether selling pressure now builds up in the most-active to the point where the index drops into minus territory. If this occurs, I would say that there is a good chance that the 921.28 high closing of February 10, 1972, will stand as roughly the high for this year.

DOW ADVANCE-DECLINE RATIO: The N.Y.S.E. A-D ratio has now gained a wide following, as have many other indicators which only a few years ago were part of the technical analyst's "mysterious treasure trove". Even the daily stock market reports which come over the radio refer to the ratio of issues which advance or decline. As a result, I have been looking around for another indicator which would "confirm" the A-D ratio and one that would not be followed by every analyst on Wall Street.

Since I have long preferred the Dow short interest ratio rather than the short interest ratio of the N.Y.S.E. (the latter is the widely-accepted indicator), I also turned to the idea of an A-D index for the 30 Dow stocks. Last July I began keeping figures on the Dow A-D index, and this often necessitated taking the actual daily count. Since the total number of stocks which I deal with always stays at 30, there was no point dividing by total issues traded (as is the case with the regular A-D ratio), and thus I used a simple plurality of the 30 issues which advanced or declined each day. In other words, if 6 Dow stocks rose and 14 fell on a given day, the figure would be a minus 8 which was subtracted from the preceding day's total.

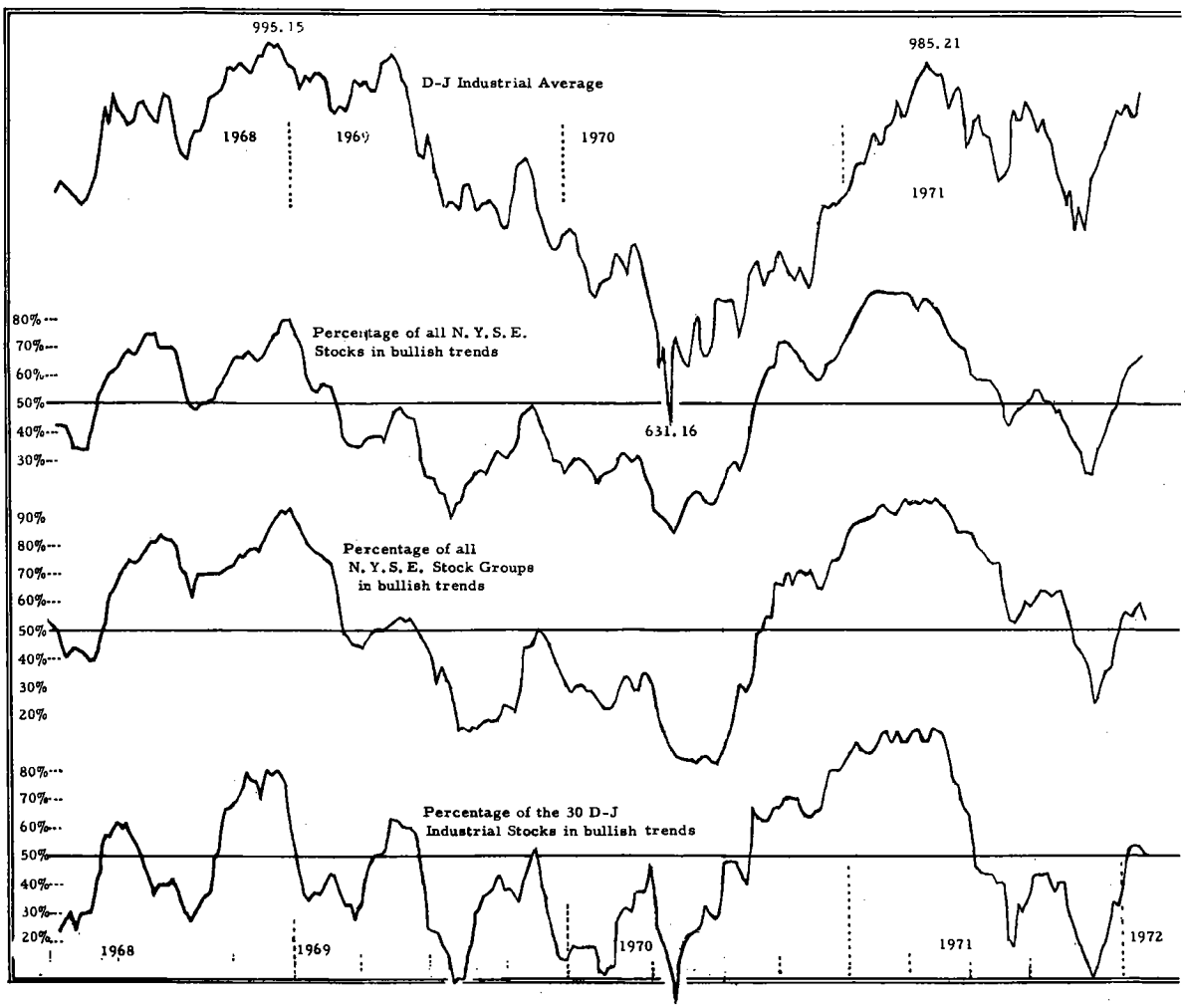
The accompanying chart shows the Dow Industrial Average (daily) superimposed upon the Dow A-D ratio for the last eight months. I would say that the steeper declines and shallower advances in the A-D index indicate that there was a great deal of selectivity on the advances in the Dow, but there was broad participation during the decline. Thus the August-September rally in the Dow A-D index did not take the index above its July peak. Again, during the November-February rally the index did not recover above even its October peak while the Dow Industrial Average pushed to a new recovery high.

A most interesting divergence began on January 11, 1972, when the Dow closed at 912.10 (marked 1 on the chart). A minor sell-off developed, and the Dow then rallied to a January 18 peak of 917.22 (marked 2 on the chart). As you can see, the Dow



 A-D index failed at 2 to better its peak at 1. Following this non-confirmation, a further decline carried to January 26 (Dow at 989.15), and a third rally then started. On February 10, the Dow recorded a recovery high of 921.28, and here for a third time (3 on the chart) the Dow A-D index failed to confirm.

This triple non-confirmation between the Dow Industrials and the Dow A-D index was most interesting, because it did not show at all on the regular A-D ratio. Therefore, it will be most interesting to see the resolution of the current triple non-confirmation as shown on this chart. If the present triple non-confirmation appeared on the regular A-D ratio, I would take it as a flagrant signal of danger. Appearing as it does on the Dow A-D ratio, I would say that it certainly suggests that weakness is appearing in the D-J Industrial Average. We will see how this works out during the several weeks ahead.



BULLISH PERCENTAGES: I am including my bullish percentages chart, a study which last appeared in Letter 506. This chart (tabulations from Chartcraft, Larchmont, N.Y. 10538) shows (1) The D-J Industrials, (2) the percentage of all N.Y.S.E. issues which are in bullish trends, (3) the percentage of all stock groups which are bullish, and (4) the percentage of the 30 D-J Industrial stocks which are bullish.

I have been watching this chart with interest, and what has particularly interested me is the relative sluggish recovery in the bullish percentage of all N.Y.S.E. issues and all N.Y.S.E. groups. But the really interesting indicator is the bullish percentage of the 30 Dow Industrial stocks. After rising temporarily above the critical 50% level during the past month, the bullish percentage of the Dow stocks now rests barely above the half-way mark. This is not the type of action associated with a major advance in the market, and the fact that the entire rise since the 1970 lows has occurred with less than half of the Dow stocks bullish suggests a great deal of selectivity rather than broad participation among the 30 Dow Industrials.

Over the past few weeks the advance-decline ratio has been acting a good deal better than the Dow Industrial Average. This is widely taken to be "bullish", but I personally am very skeptical. Obviously, the lower quality stocks are now being bought by the speculators while the investors appear to be either selling or very wary of the blue-chip Dow issues. When quality is neglected in favor of speculative appeal, the market is always on dangerous ground. This, I believe is the story told if we compare the bullish percentage of all N.Y.S.E. issues with the bullish percentage of the 30 Dow Industrials.

THE PICTURE: On February 10 the dollar sank to new all-time lows in money exchanges throughout the Free World amid tired and exasperated words by U.S. officials to the effect that all would be well, and that the "Smithsonian Agreements" would hold up if only the U.S. had enough time. Already Treasury-Secretary Connally is saying that it may take 18 months before the effects of the new trade agreements and monetary realignments produce favorable results for the U.S. balance of payments. And Reserve Board Chairman Arthur Burns states that he has "no patience" with those who say that the monetary agreements are already in a state of disarray.

Yet the fact is that no amount of "magic" monetary realignments or even a major hike in the price of gold can cure the problems of a nation which is hell-bent on an inflationary policy so flagrant and so immoral that it sweeps all before its path. The American people no longer believe that their Government has the will, know-how or strength to halt inflation. The unions are now flaunting their power before Governmental agencies which are fast becoming a laughing stock. Manufacturers continue to boost their prices, and both wholesale and retail prices continue to climb along with wages.

In the face of this, foreign creditors (dollar holders) of the U.S. see the writing on the wall. And the word is "get out of dollars while they still call them dollars". One of the avenues of escape is gold bullion, and the gold picture is clear enough if you will turn to the chart on page 6. A second "escape port" for dollars is in the stock market, and undoubtedly a certain amount of foreign dollars are moving into the N.Y.S.E. A third haven in the storm is "things" of value, hence, the renewed surge of interest in everything from old comic books, match books covers, flintlocks and cigar bands to classic antiques, stamps, coins and books on "how to make a million". Behind the explosion of new publications dedicated to wealth and power lies the fear that whatever wealth and power Americans possess today is steadily and systematically being forced down the drain by Government-sponsored inflation.

One of the dangers and ironies of the current situation is that it now requires a greater and greater ballooning of the money supply to produce less and less in the way of real expansion and growth in the economy. This is the thesis which has been illustrated many times in the Bank Credit Analyst edited by Donald Storey. From this stems the consternation regarding the present sluggish lift in the economy, despite the most massive peacetime budget deficits in U.S. history. In other words, it is taking more and more to produce less and less, but this very process itself results in virulent inflation, even if it fails to bring about a reasonable rise in profitability.

In his latest (February 8) report, economist Eliot Janeway talks about the "flash in the pan" kind of improvement in industry which is now the rule rather than the exception. He mentions the airline industry, which is fading from its earlier hopes of a big rise in high margin loads, the steel and chemical industries which are suffering from eroding price structures, and the paper industry which is now a sluggish performer.

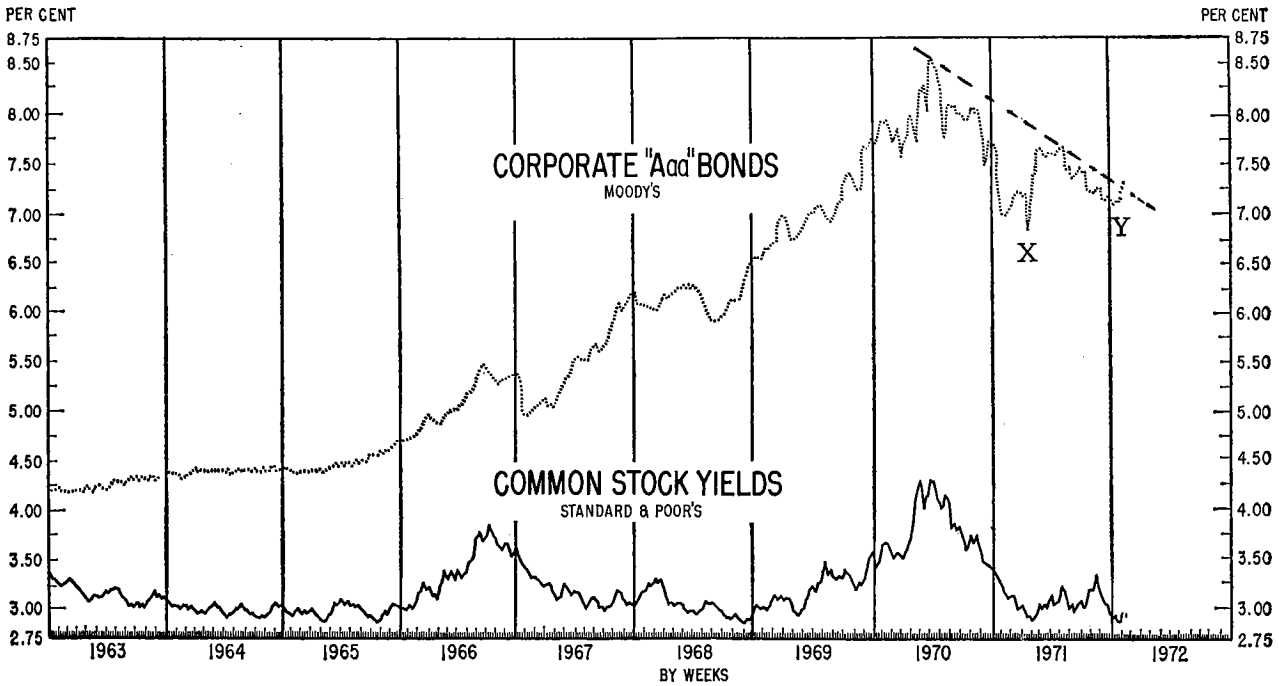
My own feeling is that the public is now being bombarded with such a mass of economic propaganda that it is becoming totally disillusioned regarding the possibility of ever learning the truth. Last week Thomas Benham, President of Opinion Research Corp. told a White House gathering of 1500 top executives that some 60% of the public gives "little approval" to business in 1971, compared with 47% in 1965. Only 11% expressed "high approval" in 1971, compared with 20% in 1965 (1965 was the year before the bull market top).

Meanwhile (again thanks to Mr. Janeway for this information) the rumor is that a feud has broken out between Mr. Connally and the White House. The argument is over the fearful size of the U.S. budget deficits — and the continuance of massive spending in the face of those deficits (although it must be admitted that the shortfall in tax receipts, a result of sluggish business, has contributed heavily to the budget deficits). All of which may explain (see last Letter) why Mr. Connally is getting the urge to exit from the Treasury and head back to Texas. But until he does, there will be friction between the Treasury and the White House (and it is well to remember that the Bureau of the Budget resides in the White House).

It is my opinion that the budget deficits coming up will wreak havoc within this nation, and I do not think that the full seriousness of the situation has begun to dawn on Wall Street, much less the rest of the country. But the budget fiasco has premeated the bond markets, and it has hit the D-J Utility Average (which has now fallen to within 2 points of its low for the year). I have included a chart (page 6) from the latest Weekly Bond Buyer showing that dangerous situation, miniscule common stock yields and high bond yields about to turn even higher. Note on the bond yield line that the recent low at "Y" was not as low as the 1971 low at "X" and that the bond yield line has now reversed the downtrend line from the 1970 peak. This is calling for higher bond yields ahead, and it indicates an end to the two-year decline in bond yields.

The outcome of this whole situation, as usual, will be a move to higher taxes. These "should" come now, but they will be put off until after the elections. It is probable that the value-added tax will be the next American blessing, and of course VAT is simply a polite name for a national sales tax. VAT will be the Administration's attempt to bring the 1973 deficit down from the area of "totally out of control" to the area of merely "shocking".

So it goes, as the U.S. continues to mortgage its present and bankrupt its future, this nation is tying itself into a fiscal bind so tight that the first recession in business will send its debt structure crashing around its ears, while at the same time running interest rates will rocket through the roof (as the Government and everybody else tries to raise money merely to service their debts). So the shots of heroin and adrenalin will have to be bigger and bigger. The drug doses will continue to grow until the patient keels over and heads towards earth again.



GOLD-SILVER: Below is the regular gold and silver chart, and here we can see that following the record recent peak of $49.25 in London, gold sold off to the $47 level, and by February 16 the bullion price was within $1 of its record high again. I feel that sometime during the next year gold and gold stocks will grab the spotlight and the results of the U.S. fiat money explosion will set off a broad movement into the yellow metal and the stocks of the gold producers. Silver, though still sluggish, seems to be extending its base, and many of the silver stocks have already moved well above recent lows.

The Amro-Pierson international stock average, reflecting the fear of monetary inflation, has been climbing towards its 1971 high. Many stocks are now being bought, not for earning power (which is the only valid reason for ever purchasing an equity) but because they appear to be a good hedge against the ravages of inflation. When equities are bought for insurance against inflation, they are being purchased on a rationale which is thin. For the same inflation which drives people into equities always either wrecks the markets or wrecks the country. In either case, the outcome is the same. In the meantime, watch for a London gold closing above $50. I feel that figure will be very significant.